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# The Sarbanes-Oxley Act: A Bird's-eye View

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## THE SARBANES-OXLEY ACT: A BIRD'S-EYE VIEW

Niels Schaumann<sup>†</sup>

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### I. INTRODUCTION

The last few years have been stressful for investors, and perhaps no less so for corporate managers. In March 2000, the

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tech stock bubble burst, inflicting financial pain on corporate<sup>1</sup> and middle<sup>2</sup> America. The following year, the public's faith in the integrity of the financial markets was shaken when a scandal erupted regarding the integrity of research reports from securities analysts at several major brokerage firms.<sup>3</sup> Later that year, Enron Corp. declared bankruptcy after revelations of financial manipulation and what appeared to be accounting fraud.<sup>4</sup> The Enron disaster took with it one of the nation's largest and most-respected accounting firms, Arthur Andersen.<sup>5</sup> More bad news soon began to surface about other large companies, including some that were recently the market's biggest success stories, including Worldcom<sup>6</sup> and Adelphia.<sup>7</sup> In mid-2002, Congress

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1. For example, shortly before the bubble burst, America Online ("AOL") had agreed to acquire Time Warner in a stock exchange. When announced on January 10, 2000, the transaction was valued at \$160 billion based on AOL's stock price. See Steven Lipkin & Kara Scannell, *Deals & Deal Makers: The Deal, Week 2: Time Warner, Media Firms Look Like Winners*, WALL ST. J., Jan. 17, 2000, at C17. After the bubble burst, the completed merger was worth just \$106 billion. A few years after the acquisition, AOL Time Warner changed its name back to Time Warner and the stock symbol from AOL to TWX, Time Warner's symbol before the acquisition. *Recent Changes in Stock Listings*, WALL ST. J., Oct. 16, 2003, at C5.

2. Investor losses following the bubble's burst are estimated at \$3 trillion. Jonathon Clements, *Getting Going, Learning Lessons from Market Losses*, WALL ST. J., Dec. 5, 2000, at C1. The Wilshire Total Market Index would show a decline of more than \$7 trillion between March 24, 2000 and July 18, 2002. Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449, 517 n.51 (2002) (citing Seth W. Feaster, *The Incredible Shrinking Stock Market*, N.Y. TIMES, July 21, 2002, at 14).

3. See Steve Liesman et al., *When Rules Keep Debt Off the Books, Enron Crisis Puts Spotlight on the FASB*, WALL ST. J., Jan. 18, 2002, at C1; Joel Seligman, *No One Can Serve Two Masters: Corporate and Securities Law After Enron*, 80 WASH. U. L.Q. 449, 451 (2002); Robert Strauss, *Investing: Asking Directions at Wall & Broad*, N.Y. TIMES, Apr. 1, 2001, § 3, at 12.

4. See Richard A. Oppel, Jr. & Andrew Ross Sorkin, *Enron's Collapse: The Overview; Enron Corp. Files Largest U.S. Claim for Bankruptcy*, N.Y. TIMES, Dec. 3, 2001, at A1; Richard B. Schmitt, *Fall of a Power Giant: Burst of Chapter 11 Filings Marks Big Year for the Bankruptcy Bar*, WALL ST. J., Dec. 4, 2001, at A10.

5. See Larry Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 6 (2002) ("Arthur Anderson has been virtually shut down by its conviction for Enron-related obstruction of justice . . ."); Robert Frank & Ken Brown, *Andersen: Just a Shadow of Its Former Self*, WALL ST. J., Apr. 30, 2002, at C1.

6. See Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 WASH. U. L.Q. 329, 333 (2003); Jared Sandberg et al., *Worldcom Admits \$3.8 Billion Error in Its Accounting*, WALL ST. J., Jun. 26, 2002, at A1.

7. Frank C. Allen, Jr., *Legal Compliance in Maritime Operations: Charting Your Course Through Stormy Waters—2003 and Beyond*, 77 TUL. L. REV. 1141, 1143 (2003);

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responded by enacting the Sarbanes-Oxley Act of 2002 (the "Act" or "SOX").<sup>8</sup> The Act's principal objective was to restore faith in the financial markets chiefly by improving the reliability of issuer disclosure.<sup>9</sup> To accomplish this goal, SOX established a board to oversee firms providing auditing services to public companies, required auditing firms to remain strictly independent of the companies they audit, increased the responsibilities of issuer audit committees, required certification of financial statements by management, specified additional and improved disclosure and financial reporting, prohibited certain activities by issuer management, created new financial crimes, and enhanced civil and criminal penalties for misdeeds already defined.

Whether the goals of SOX will be accomplished only time will tell.<sup>10</sup> What already is clear, however, is that it represents the farthest-reaching reform of federal securities law since the enactment of the Securities Exchange Act of 1934 (the "1934 Act").<sup>11</sup> Indeed, SOX is not limited to federal securities law but, as we shall see, extends its reach to state corporation law as well. As is common in securities law, large portions of the Act do not themselves create substantive regulation, but, rather, authorize the S.E.C. to adopt implementing rules. At this writing, the S.E.C. has adopted rules addressing most areas under SOX, but more rules are pending. This article will address only final rules the S.E.C. has adopted; it will not address proposed rules because the history of S.E.C. rulemaking reveals that rules often are substantially changed before being adopted.

SOX covers all issuers—domestic and foreign—with securities registered under the 1934 Act section 12.<sup>12</sup> It also covers issuers

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Jerry Markon & Peter Grant, *Prosecutors to Seek Indictments of 5 Former Adelphia Executives*, WALL ST. J., Sept. 18, 2002, at A8.

8. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (to be codified in scattered sections of 11 U.S.C., 15 U.S.C., 18 U.S.C., 28 U.S.C. and 29 U.S.C.).

9. *Id.* Preamble to Sarbanes-Oxley Act.

10. SOX did not succeed in preventing or inducing discontinuance of long-standing abuses in the mutual fund industry, which came to light beginning in late 2003. See Michael Schroeder, *New Rules for Mutual Funds*, WALL ST. J., Dec. 3, 2003, at D1 (discussing potential reforms resembling Sarbanes-Oxley). Deborah Solomon, *SEC Chairman Defends Decision to Quickly Settle Putnam Charges*, WALL ST. J., Nov. 18, 2003, at D9 (describing criticism of the SEC for failing to uncover abuse in the fund industry sooner).

11. 15 U.S.C. §§ 78a-78mm (2000).

12. Sarbanes-Oxley Act § 2(a)(7), 116 Stat. at 747 (to be codified at 15 U.S.C. § 7201). Section 12 requires registration of securities that are traded on a national

required by section 15(d) of that Act to file reports, whether or not they have securities registered under section 12.<sup>13</sup> Finally, SOX covers companies that file a registration statement under the Securities Act of 1933 (the "1933 Act").<sup>14</sup> In this article all such issuers are referred to simply as "issuers."

It is the goal of this article to provide a brief reference to the multitude of changes in the law wrought by SOX. The author's hope is that this will be of use to students, scholars, and practitioners seeking an overview of the extensive changes resulting from this legislation. The discussion is broader than it is deep; indeed, a work attempting to examine SOX in depth would soon become a treatise and not just an article. The remainder of this article, then, will seek to provide a big-picture view of SOX: Part II of this article will address SOX regulation of professionals, including accountants, lawyers, and securities analysts. Part III will address SOX's attempts to enhance corporate disclosure. Part IV will examine SOX's efforts to reform corporate governance. Part V will examine SOX's provisions dealing with enforcement of the law. Finally, Part VI will provide a brief conclusion.

## II. SOX REGULATION OF PROFESSIONALS

The cornerstone of SOX is increased oversight of the accounting and legal professions, as well as some additional regulation of securities analysts. Of these, the most dramatic changes are in the regulation of issuers' accountants.

### A. *Regulation of Accountants*

Post-SOX, accountants are subject to regulation by the Public Company Accounting Oversight Board. In addition, SOX prescribes detailed rules designed to ensure auditor independence from issuers.

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stock exchange or have reached a certain size in total assets and number of shareholders. *See* Securities Act of 1933, 15 U.S.C. § 78l(a), (b) (2000).

13. Sarbanes-Oxley Act § 2(a)(7), 116 Stat. at 747 (to be codified at 15 U.S.C. § 7201).

14. *Id.* The 1933 Act generally requires persons proposing to offer securities to the public to file a registration statement with the S.E.C. prior to offering any of the securities. Securities Act of 1933, 15 U.S.C. § 77(e)(c) (2000).

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### 1. *Public Company Accounting Oversight Board*

SOX establishes the Public Company Accounting Oversight Board as a self-regulatory organization<sup>15</sup> ("SRO"), similar in many respects to other SROs such as the New York Stock Exchange and the National Association of Securities Dealers.<sup>16</sup> In addition, SOX prohibits certain relationships between auditors and their clients, discussed below,<sup>17</sup> that might create a conflict of interest or provide a motive for the auditors to be less than exacting in their audit.

Formally, the Public Company Accounting Oversight Board (the "Board") is not an agency of the U.S. government; it is a nonprofit corporation<sup>18</sup> organized under the District of Columbia Nonprofit Corporation Act.<sup>19</sup> The Board comprises five members,<sup>20</sup> of which two must—and only two may—be certified public accountants.<sup>21</sup> If the chair is a CPA, he or she may not have been practicing as such for at least five years before being appointed to the Board.<sup>22</sup> Board members serve five-year terms, with one member's term expiring each year.<sup>23</sup> No member may serve more than two terms on the Board.<sup>24</sup>

The duties of the Board include: registering public accounting firms that prepare audit reports for issuers; establishing standards for audit reports, including standards for auditing, quality control, ethics, independence, and others as the Board deems appropriate; inspecting registered accounting firms; investigating and

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15. Sarbanes-Oxley Act § 101(a), 116 Stat. at 750 (to be codified at 15 U.S.C. § 7211).

16. The SROs design, implement and enforce their own rules after giving notice to and receiving comment from the S.E.C. 15 U.S.C. § 78s(b) (2000). The SROs also enforce S.E.C. rules and regulations over brokers, dealers, and others. *Id.* § 78s(g). In that respect, the SROs play an important role in diverting enforcement efforts from the overburdened S.E.C. The S.E.C. maintains supremacy over the SROs by reserving authority to review the SROs rules, by requiring that the SROs provide the S.E.C. with notice of final disciplinary actions, and by hearing appeals from SRO decisions. *Id.* § 78s.

17. See *infra* notes 40-57 and accompanying text.

18. Sarbanes-Oxley Act § 101(b), 116 Stat. at 750 (to be codified at 15 U.S.C. § 7211).

19. *Id.* See District of Columbia Nonprofit Corporation Act, D.C. CODE ANN. § 29-501-599.16 (1981 & Supp. 1995).

20. Sarbanes-Oxley Act § 101(e)(1), 116 Stat. at 750 (to be codified at 15 U.S.C. § 7211).

21. *Id.* § 101(e)(2).

22. *Id.*

23. *Id.* § 101(e)(5)(A).

24. *Id.* § 101(e)(5)(B).

conducting disciplinary proceedings regarding registered accounting firms; enforcing SOX with respect to registered accounting firms; and doing such other things that the Board or the S.E.C. consider “necessary or appropriate to promote high professional standards among, and to improve the quality of audit services provided by, registered accounting firms.”<sup>25</sup>

Any public accounting firm that wants to prepare or issue an audit report for an issuer (or even “participate in the preparation or issuance of” such a report) must register with the Board.<sup>26</sup> An accounting firm’s application for registration must contain the accounting firm’s consent to cooperate with the Board and to produce documents and testimony to the Board, at the latter’s request, or risk having its registration revoked.<sup>27</sup> In effect, this means that all issuers subject to SOX can be investigated by the Board, as documents produced by a registered accounting firm could (and probably would) relate to an audit report for an issuer.

In furtherance of its mission, the Board is empowered to establish standards for auditing, certifying and conducting quality control regarding audits and ethics for public accounting firms.<sup>28</sup> SOX prescribes minimum standards, however, that the Board must establish. With respect to audits, SOX mandates that audit work papers must be kept for at least seven years.<sup>29</sup> In addition to the person in charge of the audit, a second person qualified under the Board’s rules (normally another person from the firm) must approve each audit report the registered accounting firm issues.<sup>30</sup> Finally, each audit report must include a report of the testing of the issuer’s internal control processes and procedures.<sup>31</sup>

With respect to quality control of accounting and auditing standards, SOX requires the Board to establish standards addressing the monitoring of professional ethics and independence from audit clients; consultation regarding accounting and auditing questions within the firm; hiring, education, and promotion of personnel; agreeing to perform, and performance of, accounting and auditing services; and internal

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25. *Id.* § 101(c).

26. *Id.* § 102(a), 116 Stat. at 753 (to be codified at 15 U.S.C. § 7212).

27. *Id.* § 102(b)(3).

28. *Id.* § 103(a)(3)(A), 116 Stat. at 755 (to be codified at 15 U.S.C. § 7213).

29. *Id.* § 103(a)(2)(A)(i).

30. *Id.* § 103(a)(2)(A)(ii).

31. *Id.* § 103(a)(2)(A)(ii). Regarding internal controls, *see infra* notes 107-110 and accompanying text.

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inspection and control.<sup>32</sup>

In furtherance of its powers to regulate the accounting profession, the Board must conduct a program of inspections to ensure the registered firms are in compliance with SOX, the Board's rules, the S.E.C.'s rules, and professional standards.<sup>33</sup> The Board, in addition to its power to inspect, also has sweeping powers of investigation and discipline, related not only to violations of its own rules, but also to violations and suspected violations of the securities laws, the S.E.C.'s rules, and professional accounting standards.<sup>34</sup> The Board may demand testimony and production of documents from registered firms or their client(s), and can seek a subpoena from the S.E.C. compelling testimony or production of documents if necessary.<sup>35</sup> The Board may refer matters to the S.E.C., and, at the latter's direction, to other authorities, including the Justice Department (for criminal violations).<sup>36</sup> The Board has the power to impose discipline on registered firms and associated persons, if it finds a violation of applicable law, rules, or standards.<sup>37</sup> The nature of the discipline the Board may impose depends on the nature of the violation; the most severe violations (those categorized as "intentional" or "knowing") can result in both a permanent bar from auditing issuers as well as substantial money penalties.<sup>38</sup> Lesser violations may result in censure, mandatory training, money penalties, and other sanctions, as the Board determines.<sup>39</sup>

## 2. Auditor Independence

In addition to establishing the Board, SOX contains detailed rules, designed to ensure auditors' independence from their issuer clients. Certain services by auditors are prohibited outright; those not prohibited are subject to pre-approval by the issuer's independent audit committee. Furthermore, audit partners (but, at this time, not audit firms) must rotate periodically, and the auditors must report to the audit committee, thereby enabling that

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32. *Id.* § 103(a)(2)(B).

33. *Id.* § 104(a), 116 Stat. at 757 (to be codified at 15 U.S.C. § 7214).

34. *Id.* § 105(b)(1), 116 Stat. at 759 (to be codified at 15 U.S.C. § 7215).

35. *Id.* § 105(b)(2).

36. *Id.* § 105(b)(4)(B).

37. *Id.* § 105(c)(4).

38. *Id.* § 105(c)(4),(5).

39. *Id.* § 105(c)(4).



committee to monitor the relationship between management and the auditors. Finally, the employment by the issuer of former auditor employees is limited.

*a. Prohibited Services*

Congress was concerned that the financial scandals of 2001-02 were caused partly because auditors had become too cozy with their clients. SOX therefore contains provisions designed to ensure that auditors remain independent, so that audit reports represent an impartial conclusion regarding the accuracy of the clients' financial statements. Of particular concern to Congress were the possible conflicts of interest generated when auditors provide non-audit services to issuers, and SOX prohibits auditors from providing certain non-audit services to their audit clients.<sup>40</sup> Prohibited services include: (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert services unrelated to the audit; and (9) any other service that the Board determines, by regulation, is impermissible.<sup>41</sup>

*b. Services Requiring Pre-Approval*

The services that are not prohibited outright must, in general, be pre-approved by the issuer's audit committee before an outside auditor may perform them.<sup>42</sup> The audit committee may delegate the power to pre-approve services to one or more members who are independent directors.<sup>43</sup> If, however, the delegated power is exercised, the delegated pre-approvals must be presented to the full audit committee at the next scheduled meeting.<sup>44</sup>

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40. *Id.* § 201(a), 116 Stat. at 771-72 (to be codified at 15 U.S.C. § 78j-1) (adding § 10A(g) to the Securities Exchange Act of 1934).

41. *Id.* § 201(g). *See* Rule 2-01 of Regulation S-X, 17 C.F.R. § 210.2-01 (2002) (restricting the services an auditor may provide to issuers).

42. Sarbanes-Oxley Act § 202, 116 Stat. at 772 (to be codified at 15 U.S.C. § 78j-1) (adding § 10A(i)(1) to the Securities Exchange Act of 1934).

43. *Id.* (adding § 10A(i)(3) to the Securities Exchange Act of 1934).

44. *Id.*

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The requirement of pre-approval applies to both audit and non-audit services.<sup>45</sup> "Audit services" include comfort letters issued in connection with the issuer's offering securities, and thus go beyond the typical understanding of services included in an audit.<sup>46</sup> Excluded from the *pre*-approval requirement (but still requiring approval) are certain *de minimus* non-audit services, if they (1) account for less than five percent of the fees paid to the auditor by the issuer in the year in which they were rendered, (2) were not recognized as non-audit services at the time the outside auditors were engaged, (3) are promptly brought to the audit committee's attention, and (4) are approved before the completion of the audit.<sup>47</sup> Finally, not only do all non-audit services need to be approved (most of them in advance), but their approval must be disclosed in the issuer's periodic reports filed under 1934 Act section 13(a).<sup>48</sup>

*c. Rotation of Audit Partners*

SOX contemplates that a registered accounting firm auditing an issuer will have one person responsible for supervising the audit and one person responsible for reviewing the supervisor's work.<sup>49</sup> Neither of these persons may provide audit services to the issuer for more than five consecutive years.<sup>50</sup> Rotation of audit *firms* is not required; however, the Comptroller General of the United States is directed by SOX to study the pros and cons of rotating audit firms and to report to Congress.<sup>51</sup>

*d. Auditor Reports to Audit Committee*

Outside auditors must timely report to the issuer's audit committee regarding: (1) all critical accounting policies and practices to be used; (2) alternative treatments of financial information (within GAAP) that have been discussed with

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45. *Id.*

46. *Id.* (adding § 10A(i)(1)(A) to the Securities Exchange Act of 1934).

47. *Id.* (adding § 10A(i)(1)(B) to the Securities Exchange Act of 1934). *See* Rule 2-01 of Regulation S-X, 17 C.F.R. § 210.2-01 (2002) (restricting the services an auditor may provide to issuers).

48. Sarbanes-Oxley Act § 202, 116 Stat. at 772 (to be codified at 15 U.S.C. § 78j-1) (adding § 10A(i)(2) to the Securities Exchange Act of 1934).

49. *Id.* § 203, 116 Stat. at 773 (to be codified at 15 U.S.C. § 78j-1) (adding § 10A(j) to the Securities Exchange Act of 1934).

50. *Id.*

51. *Id.* § 207(a)(b), 116 Stat. at 775 (to be codified at 15 U.S.C. § 7232).

management, the ramifications of such alternative treatments, and the auditor's preferred treatment; and (3) all other material written communications between management and the auditors.<sup>52</sup> This has the effect of putting all material communications between management of the issuer and the outside auditors before the audit committee, which can thereby review the relationship between those two entities and ensure the independence of the auditors.

*e. Issuer Employment of Auditor Staff*

Because an issuer's outside accountants have in-depth knowledge of the issuer and the challenges it faces, it is not uncommon for personnel from an issuer's accounting firm later to take employment with the issuer. To guard against conflicts of interest, however, SOX prohibits an accounting firm from auditing an issuer if the issuer's CEO, CFO, controller, or chief accounting officer was employed by the accounting firm and participated in any capacity in the issuer's audit within the preceding twelve months.<sup>53</sup>

*f. Study of Principles-Based Accounting*

Accounting in the United States is largely "rule-based," meaning it is governed by rules that define as precisely as possible the resolution of accounting issues.<sup>54</sup> Unlike the United States, many countries have "principles-based" accounting, meaning that accounting is done under a set of principles that provide policy guidance for resolving individual issues.<sup>55</sup> Each approach has its

52. *Id.* § 204, 116 Stat. at 773 (to be codified at 15 U.S.C. § 78j-1) (adding § 10A(k) to the Securities Exchange Act of 1934). See Rule 2-07 of Regulation S-X, 17 C.F.R. § 210.2-07 (2002).

53. Sarbanes Oxley Act § 206, 116 Stat. at 774-775 (to be codified at 15 U.S.C. § 78j-1) (adding § 10A(l) to the Securities Exchange Act of 1934).

54. The rules of U.S. accounting are codified as "generally accepted accounting principles" (GAAP). *United States v. Arthur Young & Co.*, 465 U.S. 805, 811 n.7 (1984) (describing GAAP as "the conventions, rules and procedures that define accepted accounting practices"). The Financial Accounting Standards Board (FASB) promulgates GAAP standards. See Financial Accounting Standards Board, available at <http://www.fasb.org/> (last visited May 19, 2004) ("The mission of the Financial Accounting Standards Board is to establish and improve standards of financial accounting and reporting for the guidance and education of the public . . .").

55. See Fredrick Gill, *Principles-Based Accounting Standards*, 28 N.C.J. INT'L L. & COM. REG. 967 (2003); Peter Jeffrey, *International Harmonization of Accounting Standards, and the Question of Off-Balance Sheet Treatment*, 12 DUKE J. COMP. & INT'L L.

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strengths and weaknesses. After the financial scandals of 2001-02, however, some observers believed that the U.S. rule-based system encouraged issuers and accountants to stray too close to the edge, complying with the letter of the rule while avoiding its spirit.<sup>56</sup> The rules might communicate precisely what not to do in order to avoid breaking the law, leaving it open for issuers and their auditors to accomplish the same result by other means. Section 108(d) of SOX directs the S.E.C. to study the possibility of implementing a principles-based accounting system in the United States, and to report to Congress on the results.<sup>57</sup> If the S.E.C. were to recommend changing to a principles-based system, and Congress and the Board were to concur, it likely would be the most dramatic reform of financial reporting in the history of the United States.

### *B. Regulation of Lawyers*

To this point we have addressed the extensive regulation of accountants imposed by SOX. SOX also addresses the professional responsibility of lawyers, although in a less comprehensive manner. There is not, for example, a body similar to the Public Company Accounting Oversight Board to register attorneys practicing before the S.E.C., nor are the duties applicable to attorneys spelled out in as much detail as they are for accountants. Nevertheless, section 307 of SOX requires the S.E.C. to adopt rules "setting forth minimum standards of professional conduct for attorneys . . . ."<sup>58</sup> As the following sections will reveal, the S.E.C.'s rules regarding attorneys are complex and require careful attention by practitioners. S.E.C. regulation of attorneys<sup>59</sup> has been controversial in the past,<sup>60</sup> and the controversy is likely to continue under SOX.

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341 (2002).

56. See S. REP. NO. 107-205, at 13 (2002); FASB, *Proposal, Principles-Based Approach to U.S. Standard Setting* (Oct. 21, 2002), available at [http://www.fasb.org/proposals/principles-based\\_approach.pdf](http://www.fasb.org/proposals/principles-based_approach.pdf) (last visited May 19, 2004).

57. Sarbanes-Oxley Act § 108(d), 116 Stat. at 768 (to be codified at 15 U.S.C. § 77s).

58. *Id.* § 307, 116 Stat. at 784 (to be codified at 15 U.S.C. § 7245).

59. See S.E.C. Rules of Practice, 17 C.F.R. pt. 201 (2002). The Rules of Practice set out standards for attorneys practicing before the S.E.C. and authorize the S.E.C. to suspend or disbar attorneys who violate those standards. *Id.* § 201.102. The most commonly addressed violations include: lack of qualifications, defect of personal character, unethical conduct, and the violation of securities laws. *Id.* § 201.102(e)(1).

60. See, e.g., *In re George C. Kern, Jr.* (Allied Stores Corp.), Admin. Proc. File No. 3-6869 (Nov. 14, 1988) [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH);

### 1. *“Up-the-ladder” Reporting*

SOX mandates “up-the-ladder” reporting of a material violation of securities law, breach of fiduciary duty, or similar violation by the issuer or any of its agents. Up-the-ladder reporting means that the lawyer who becomes aware of material evidence of such a violation must report it (a) first, to the chief legal officer of the issuer, and if that person does not provide an appropriate response, then (b) further, to the audit committee or another board committee composed of only independent directors.<sup>61</sup> Up-the-ladder reporting is not triggered, however, until the lawyer has “evidence of a material violation of securities law or breach of fiduciary duty or similar violation . . . .”<sup>62</sup> The phrases “evidence of a material violation of securities law or breach of fiduciary duty or similar violation” and “appropriate response” are critical, as they trigger the requirement to report up the ladder.

#### a. *“Evidence of Material Violation”*

The S.E.C.’s new professional conduct rules<sup>63</sup> define “evidence of a material violation” as “credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.”<sup>64</sup>

#### b. *“Breach of Fiduciary Duty”*

Under the S.E.C.’s professional conduct rules, “breach of fiduciary duty refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable federal or state statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions.”<sup>65</sup>

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*In re* Carter and Johnson, 47 S.E.C. 471 (1981).

61. Sarbanes Oxley Act § 307, 116 Stat. at 784 (to be codified at 15 U.S.C. § 7245).

62. *Id.*

63. Standards for Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. pt. 205 (2003) (adopting standards required by Sarbanes-Oxley Act § 307).

64. 17 C.F.R. § 205.2(e).

65. *Id.* § 205.2(d).

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*c. "Appropriate Response"*

This term is important because if the reporting lawyer determines that the response she receives is not appropriate, she is required to go further up the ladder to the audit or other board committee. For purposes of the professional conduct rules, “‘appropriate response’ means a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes: (1) That no material violation . . . has occurred, is ongoing, or is about to occur”; (2) that the issuer has taken appropriate measures to remedy or prevent material violations; or (3) “that the issuer has . . . retained or directed an attorney to review the reported evidence of a material violation” and either has substantially implemented any remedial recommendations made by the attorney or the attorney may assert a colorable defense on behalf of the issuer or agent in any proceeding relating to the reported evidence of a material violation.<sup>66</sup>

*2. Attorney-Client Privilege and “Noisy Withdrawal”*

One of the more controversial aspects of the S.E.C.’s efforts to regulate lawyers has been its attempts to force lawyers to report wrongdoing by their clients to the government; this raises issues about attorney-client privilege when, for example, the attorney has learned of past wrongdoing in a privileged communication.<sup>67</sup> SOX preserves attorney-client privilege because up-the-ladder reporting remains within the corporate client (*e.g.*, to chief legal officer, audit committee, etc.), and the reporting attorney has not thereby violated the privilege. If the lawyer were required to report to third parties, however, such a report might well violate the privilege and that could leave the lawyer open to professional discipline under state law.

What happens if lawyers report up the ladder to no avail? As originally proposed, the rules implementing SOX section 307 required such lawyers to withdraw from representation of the client, to notify the S.E.C. that they had done so for ethical reasons,

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66. *Id.* § 205.2(b).

67. The American Bar Association’s Professional Conduct Rule 1.6 forbids an attorney’s disclosure of a client’s past acts if that information was gained through a privileged attorney-client communication. MODEL RULES OF PROF’L CONDUCT R. 1.6 (2002).

and to disaffirm any questionable S.E.C. filings the issuer has made.<sup>68</sup> Such a withdrawal is called “noisy” because of the requirement that the withdrawing lawyer notify the S.E.C. and disaffirm filings. Because they require some reporting to third parties (namely, the S.E.C.), the noisy withdrawal rules might require lawyers to violate the attorney-client privilege and, unsurprisingly, the rules drew a firestorm of criticism from the bar.<sup>69</sup> After the reaction of the bar became known, a revised “noisy withdrawal” rule was proposed.<sup>70</sup> The S.E.C. has not taken action on the new proposals yet, but securities lawyers eventually may become subject to a noisy withdrawal requirement in some form.<sup>71</sup>

### 3. *Statutory Basis for Attorney Discipline*

Rule 102(e) of the S.E.C.’s Rules of Practice<sup>72</sup> gives the S.E.C. authority to discipline attorneys practicing before it.<sup>73</sup> Before SOX was passed, the S.E.C. did not have an express statutory basis for this rule, but rather relied on its general rulemaking powers and its inherent authority under the securities laws.<sup>74</sup> Section 602 of SOX, however, essentially codifies rule 102(e) and thereby provides an explicit statutory basis for the Commission’s power to discipline attorneys.<sup>75</sup>

#### a. *Appearing and Practicing Before the S.E.C.*

The S.E.C. has disciplinary powers over lawyers “appearing and

68. Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 33-8150 (proposed Nov. 21, 2002), 67 Fed. Reg. 71, 670, 71, 673 (Dec. 2, 2002), *available at* <http://www.sec.gov/rules/proposed/33-8150.htm> (last visited May 19, 2004).

69. See Final Rule: Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 33-8185 (Jan. 29, 2003), 68 Fed. Reg. 6296 (Feb. 6, 2003), *available at* <http://www.sec.gov/rules/final/33-8185.htm> (last visited May 19, 2004).

70. Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 33-8186 (Jan. 29, 2003), 68 Fed. Reg. 6324 (Feb. 6, 2003), *available at* <http://www.sec.gov/rules/proposed/33-8186.htm> (last visited May 19, 2004).

71. *Id.*

72. 17 C.F.R. pt. 201 (2002) (predating Sarbanes-Oxley).

73. 17 C.F.R. § 201.102(e) (2004).

74. Judicial review of the S.E.C.’s rulemaking authority has been favorable to the S.E.C. See, e.g., *Touche Ross & Co. v. S.E.C.*, 609 F.2d 570 (2d Cir. 1979).

75. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 602, 116 Stat. 747, 794 (2002) (to be codified at 15 U.S.C. § 78d-3) (amended by adding § 4C(a) to the Securities Exchange Act of 1934).

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practicing before [it] in any way.”<sup>76</sup> The S.E.C.’s rules define “appearing and practicing” as follows:

(i) Transacting any business with the Commission, including communications in any form; (ii) Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena; (iii) Providing advice in respect of the United States securities laws or the [S.E.C.’s] rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to the [S.E.C.], including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or (iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required . . . to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the [S.E.C.].<sup>77</sup>

In addition, a lawyer retained or (if in-house) directed to investigate evidence of a material violation, which has been reported under the up-the-ladder procedures, is deemed to be “appearing and practicing” before the S.E.C.<sup>78</sup>

“Appearing and practicing” does *not* include a lawyer who: “(i)

76. *Id.*

77. Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.2(a) (adding the standards required by Sarbanes-Oxley section 307). The S.E.C.’s Standards for Professional Conduct define “appearing and practicing” before the S.E.C. more narrowly than do the Rules of Practice. Under the latter, “practicing before the Commission” includes for example, the preparation, or participation in the preparation, of any paper, by any attorney, filed with the S.E.C. in any document. 17 C.F.R. § 201.102(f). The Standards, however, define “appearing and practicing” before the S.E.C. as communicating with the S.E.C. “in any form”; representing an issuer in connection with an S.E.C. administrative proceeding or investigation (including informally such as S.E.C. requests for information and inquiries, as well as subpoenas); providing advice in respect of the United States securities laws or S.E.C. rules regarding any document filed with the S.E.C., “including *the provision of such advice in the context of preparing, or participating in the preparation of, any such document*”; and providing advice on the need to file any document with the S.E.C. 17 C.F.R. § 205.2(a) (emphasis added). The italicized language requires that securities law advice be rendered, and thus appears to be a retreat from the position of the Rules of Practice, which make the preparation of a filed document “practicing before the Commission” regardless whether securities law advice is provided.

78. 17 C.F.R. § 205.3(b)(5) (2004).



Conducts the activities [described above] other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship; or (ii) Is a non-appearing foreign attorney.”<sup>79</sup>

#### 4. *Sanctions for Violation of the Attorney Conduct Rules*

Rules for attorney conduct lack influence if they are not enforceable. SOX section 602 therefore provides that the S.E.C. may censure a violating lawyer or deny the violator the privilege of appearing and practicing before it.<sup>80</sup> The S.E.C.’s implementing rules<sup>81</sup> echo this authority, and, in addition, expressly authorize the S.E.C. to “subject such attorney to the civil penalties and remedies for a violation of the federal securities laws available to the Commission in an action brought by the Commission thereunder.”<sup>82</sup> The latter phrase potentially could bring into play the full spectrum of remedies available to the S.E.C. in civil or administrative proceedings.<sup>83</sup>

#### 5. *Role of the “Qualified Legal Compliance Committee”*

No discussion of the new standards for professional conduct governing securities lawyers would be complete without mention of the “qualified legal compliance committee” (“QLCC”). An issuer may form a QLCC to take responsibility for legal compliance issues.<sup>84</sup> The QLCC must include at least one member of the issuer’s audit committee and two or more independent members of the issuer’s board of directors (that is, directors who are not

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79. *Id.* § 205.2(a)(2). *See also* § 205.2(j)(1-3) (defining a “foreign attorney” as a lawyer who is licensed outside the United States, who does not advise on U.S. securities laws except in conjunction with a U.S. attorney, and who only incidentally does things that would otherwise be “appearing and practicing” before the S.E.C.).

80. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 602, 116 Stat. 745, 794 (to be codified at 15 U.S.C. § 78d-3) (adding § 4C to the Securities Exchange Act of 1934).

81. 17 C.F.R. § 205.6(b).

82. *Id.* § 205.6(a).

83. A full discussion of these is beyond the scope of this article. Briefly, however, these include injunctions, orders for disgorgement, civil penalties, forced resignations, and disbarment or suspension. *See* Securities Act of 1933 § 20(a), 15 U.S.C. § 77t(e) (2000); Securities Exchange Act of 1934 § 21(d), 15 U.S.C. § 78u(d)(2) (2000); S.E.C. Rules of Practice, 17 C.F.R. § 201.102(e).

84. 17 C.F.R. § 205.2(k).

employed, directly or indirectly, by the issuer).<sup>85</sup> The QLCC need not contain any lawyers. Perhaps that is not surprising since up-the-ladder reporting will in most cases terminate with the issuer's audit committee, which likewise need not contain any lawyers.<sup>86</sup>

A QLCC comes into play in two situations: (1) when the reporting lawyer elects to report directly to the QLCC rather than to the chief legal officer; or (2) the reporting lawyer reports the matter to the chief legal officer, who instead of taking action personally, refers the matter to the QLCC. The QLCC must establish written procedures for accepting, maintaining and considering such reports in a confidential manner.<sup>87</sup>

A QLCC must have at least the following authority:

(i) To inform the issuer's chief legal officer and chief executive officer . . . of any report of evidence of a material violation . . . ; (ii) To determine whether an investigation is necessary regarding any report of evidence of a material violation . . . and, if it determines an investigation is necessary or appropriate, to: (A) Notify the audit committee or the full board of directors; (B) Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent thereof) or by outside attorneys; and (C) Retain such additional expert personnel as the committee deems necessary; and (iii) At the conclusion of any such investigation, to: (A) Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and (B) Inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted . . . .<sup>88</sup>

Additionally, the QLCC must have authority to take all other appropriate action, including notifying the Commission in the event that the issuer fails in any material respect to implement the QLCC's recommendations.<sup>89</sup>

Most issuers will probably establish a QLCC because such a committee is more likely to prepare a coordinated response to

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85. *Id.* § 205.2(k)(1).

86. See *supra* note 61 and accompanying text.

87. 17 C.F.R. § 205.2(k)(2).

88. *Id.* § 205.2(k)(3).

89. *Id.* § 205.2(k)(4).

evidence of securities law problems than the chief legal officer, who may not have procedures developed in advance to deal with such issues. In addition, a QLCC involves the issuer's board at an early stage of the response, perhaps making an adequate response more likely.

### C. Regulation of Securities Analysts

In June of 2001, New York state investigators announced an investigation of securities analysts at several major securities firms.<sup>90</sup> The analysts were allegedly compensated in part by fees generated by investment banking deals with the issuers. The more successful an issuer was in the markets, the more investment banking business the issuer would bring to the securities firm and the higher the fees paid by the issuer (and thus, the greater the analyst's compensation).<sup>91</sup> Analysts thus were caught in a conflict of interest because favorable recommendations of an issuer's securities would generate business for the analyst's employer, that, in turn, would generate substantial bonuses and salary increases for the analyst. Analysts, therefore, were transformed from impartial researchers of a company's prospects to promoters of the company's stock. After the market bubble burst, analysts continued to issue optimistic forecasts for securities whose prices were plunging, prompting an investigation by the attorney general of New York that the federal regulators ultimately joined.<sup>92</sup> Among other things, the investigators made public certain e-mails among analysts and other brokerage employees in which the analysts spoke derisively of securities they were simultaneously recommending to public investors.<sup>93</sup> The ensuing scandal severely eroded investor confidence in the markets and ultimately led to a settlement between regulators and the securities firms totaling approximately \$1 billion.<sup>94</sup>

90. Eliot Spitzer, Attorney General of the State of New York, Affidavit in Support of Application for an Order Pursuant to General Business Law Section 354, at 2, available at <http://www.oag.state.ny.us/press/2002/apr/MerrillL.pdf> (last visited May 19, 2004); Scott Thurm, *When Do Analysts Cover Their Own Interests?*, WALL ST. J., Dec. 10, 2001, at C1.

91. Spitzer, *supra* note 90, at 3-5.

92. *Id.*; Charles Gasparino, *SEC Launches Inquiry into Wall Street Research*, WALL ST. J., May 1, 2002, at C3.

93. Spitzer, *supra* note 90, at 11-12.

94. Randall Smith & Aaron L. Lucchetti, *How Spitzer Pact will Affect Wall Street*, WALL ST. J., May 22, 2002, at C1.

Against this background it should come as no surprise that SOX regulates securities analysts, and that SOX regulation of analysts is focused on conflicts of interest. Section 501 of SOX requires either the S.E.C. or the SROs to adopt rules regulating securities analysts and research reports.<sup>95</sup> In the spring of 2003, the S.E.C. adopted Regulation AC ("Analyst Certification"), pursuant to SOX and the antifraud provisions of the 1933 and 1934 Acts.<sup>96</sup> Regulation AC is likely just the first step in regulation of analysts, and it treads somewhat cautiously. It requires that analysts' written research reports must include certifications of two kinds. First, analysts must certify that all of the views expressed in the research report accurately reflect the analyst's personal views about the subject security or issuer.<sup>97</sup> In addition, a written report must include either a statement attesting that the analyst's compensation is not related to the specific recommendations or views expressed in the research report, or, if that is not the case, accurate disclosure of the source, amount, and purpose of such compensation, and that the compensation could influence the recommendations or views expressed in the research report.<sup>98</sup>

In addition to providing written research, analysts also often appear publicly to discuss their views of particular securities and issuers. In some respects, public appearances may be even more dangerous than written reports; it is possible that investors would respond even more rapidly to a public appearance, for example on television, than to a written report. Accordingly, Regulation AC prohibits any analyst compensation based on the views the analyst expresses in a public appearance.<sup>99</sup> Under Regulation AC, analysts must certify each calendar quarter that the views expressed by the analyst in all public appearances during the quarter accurately reflected the analyst's personal views at that time about any and all of the subject securities or issuers.<sup>100</sup> Further, analysts must certify that no part of their compensation was, is, or will be directly or indirectly related to the specific recommendations or views

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95. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 501(a), 116 Stat. 745, 791 (to be codified at 15 U.S.C. § 78o-6) (adding § 15D to the Securities Exchange Act of 1934).

96. Final Rule: Regulation Analyst Certification, Exchange Act Release No. 33-8193 (Feb. 20, 2003), 17 C.F.R. § 242.500-242.505 (2003).

97. *Id.* § 501(a)(1), 17 C.F.R. § 242.501.

98. *Id.* § 501(a)(2).

99. *Id.* § 502, 17 C.F.R. § 242.502.

100. *Id.*

expressed by the research analyst in any public appearances.<sup>101</sup>

Regulation AC, however, does not completely discharge the burden of analyst regulation under SOX, which requires the S.E.C. to regulate in more areas than just conflict of interest. Briefly, SOX requires the Commission to promulgate rules: (1) restricting prepublication clearance or approval of research reports by investment bankers or others not directly responsible for investment research (other than legal or compliance staff), (2) prohibiting supervision and evaluation of analysts by investment bankers, (3) prohibiting retaliation against analysts for negative or unfavorable reports that may adversely affect the securities firms' investment banking relationships, (4) defining periods of time during which securities firms involved in a public offering are prohibited from publishing research reports related to the offered securities, (5) requiring disclosure by analysts of any investments they have in the issuer that is the subject of their report, (6) establishing institutional protections for analysts against pressure from investment bankers, and (7) requiring disclosure whether an issuer whose securities are recommended in a report is or in the past year has been a customer of the securities firm. In addition, the S.E.C. and SROs may address other issues they deem appropriate.<sup>102</sup>

So far we have considered the SOX provisions regulating certain persons involved professionally in the securities business, from accountants to lawyers and investment analysts. Missing from the discussion to this point have been the issuers themselves. They, too, are regulated by SOX, and it is to them we now turn.

### III. ENHANCED CORPORATE DISCLOSURE

#### A. *Officer Certifications*

The corporations involved in the scandals that prompted the passage of SOX had, without exception, manipulated their disclosures to investors in various ways. While SOX regulation of securities professionals is an attempt to reduce such manipulation

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101. *Id.*

102. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 501, 116 Stat. 745, 791 (to be codified at 15 U.S.C. § 78o-6) (adding § 15D to the Securities Exchange Act of 1934).

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indirectly by making the necessary professional help significantly more difficult to obtain, SOX also aims directly to enhance disclosure by public companies via several means.

First, the issuer's management is now required to certify the issuer's financial information as accurate and complete. SOX contains both civil<sup>103</sup> and criminal<sup>104</sup> provisions requiring certification of financial data. Each requires both the CEO and the CFO (or their equivalents) to certify as accurate the financial information in the company's reports filed under the 1934 Act.<sup>105</sup> By June 2003, the Justice Department had already filed charges against a corporate officer under section 906.<sup>106</sup>

Issuer reports under the 1934 Act also must contain officer certifications that the issuer has in place adequate "disclosure controls and procedures."<sup>107</sup> Disclosure controls and procedures are the processes the issuer uses to ensure that management knows of all information, financial and non-financial, necessary for the issuer to meet its reporting and disclosure obligations accurately and timely.<sup>108</sup>

In addition to these "disclosure controls and procedures" certifications, each annual report under the 1934 Act (i.e., Forms 10-K or 10-KSB) must include management's report on internal accounting controls, and the report of the issuer's outside auditors on management's report.<sup>109</sup> Internal accounting controls are different from disclosure controls and procedures, which are discussed above. Internal controls are the processes the issuer has in place to ensure that the financial reports prepared by its accountants are accurate and complete; they are a control used to ensure that the financial information the issuer generates actually reflects its own financial condition. While some internal accounting controls are also disclosure controls, there are instances where there is no overlap. For example, an issuer might require

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103. *Id.* § 302, 116 Stat. at 777 (to be codified at 15 U.S.C. § 7241).

104. *Id.* § 906(a), 116 Stat. at 806 (to be codified at 18 U.S.C. § 1350).

105. *Id.* §§ 302(a), 906(a).

106. *See* United States v. Smith, No. CR03-PT-126-S (N.D. Ala., plea entered Mar. 19, 2003).

107. Sarbanes-Oxley Act § 404, 116 Stat. at 789 (to be codified at 15 U.S.C. § 7262).

108. *Id.*; Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Exchange Act Release No. 33-8238 (June 5, 2003), 17 C.F.R. pts. 210, 228, 229, 240, 249, 270 and 274 (2003).

109. Sarbanes-Oxley Act § 404(b).

two signatures on checks over a certain amount. That would be an internal accounting control, but might not be a disclosure control.<sup>110</sup>

### B. Section 16 Reports

Section 16 of the 1934 Act<sup>111</sup> requires certain “insiders” of the issuer to file reports disclosing their ownership of the issuer’s securities and any changes in that ownership. The insiders required to report include the issuer’s directors, officers, and holders of more than ten percent of any class of the issuer’s equity securities. There is a vast amount of scholarship addressing section 16; the purpose of this section is not to summarize section 16 but rather to highlight the changes made by SOX.

First, SOX amended the 1934 Act section 16(a) to require section 16 insiders to file statements reflecting changes in their ownership of the issuer’s securities within two business days of the change.<sup>112</sup> In addition, the S.E.C. has adopted rules requiring the electronic filing of section 16(a) reports and, if the issuer maintains a corporate web site, posting of the reports on the web site.<sup>113</sup>

### C. Off-Balance-Sheet Transactions

Each annual and quarterly report filed with the S.E.C. must disclose “all material off-balance sheet transactions” and all “relationships of the issuer with . . . persons, that may have a material . . . effect on” the issuer’s financial condition.<sup>114</sup> This requirement is another response to the Enron bankruptcy, which was precipitated in part by Enron’s immense exposure in off-balance-sheet transactions<sup>115</sup> with entities controlled by its own

110. See Final Rule: Management’s Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, *supra* note 108.

111. Securities Exchange Act of 1934, 15 U.S.C. § 16 (2000).

112. Sarbanes-Oxley Act § 403(a), 116 Stat. at 788 (to be codified at 15 U.S.C. § 78p) (amending the Securities Exchange Act of 1934 by adding § 16(a)(2)(c)).

113. *Id.* Final Rule: Mandated Electronic Filing and Website Posting for Forms 3, 4 and 5, Exchange Act Release No. 33-8230 (May 7, 2003), 17 C.F.R. pts. 230, 232, 239, 240, 249, 250, 259, 260, 269 and 274 (2003) (adopting amendments to Regulation S-T, Rule 16a-3, Forms 3, 4 and 5).

114. Sarbanes-Oxley Act of 2002 § 401(a), 116 Stat. 785 (to be codified at 15 U.S.C. § 78m) (amending § 13(j) of the Securities Exchange Act of 1934).

115. Off-balance sheet transactions are transactions that, under generally accepted accounting principles, need not be disclosed to investors in the issuer’s

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insiders.<sup>116</sup> SOX also instructed the S.E.C. to study the use of off-balance sheet techniques and to report the results to Congress along with its recommendations for additional or different regulation.<sup>117</sup>

#### *D. Pro Forma Financial Information*

Issuers often present “pro forma” financial information in various documents provided to investors. Such information is designed to present results “as if” certain things were true or “as if” certain things had (or had not) taken place. Because pro forma information is not presented in accordance with GAAP, it could mislead investors who are unable to decipher for themselves what such information would look like if it reflected actual operating results and were reported under GAAP. SOX therefore requires that pro forma information be (a) presented so as not to mislead investors, and (b) reconciled with the issuer’s reports prepared under GAAP.<sup>118</sup>

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financial statements, and therefore do not appear on the balance sheet. As an example, the financial results of a company that is not a subsidiary, but merely an investment of the issuer, need not be consolidated with the issuer’s results on the issuer’s financial statements.

116. See *supra* note 115. See also Final Rule: Disclosures in Management’s Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Exchange Act Release No. 33-8182 (Jan. 28, 2003), 17 C.F.R. pts. 228, 229 and 249 (2003). For example, suppose E Corp. wants to engage in certain risky transactions without disclosing the risks. E Corp. decides to purchase a minority interest in a partnership, the majority of which is owned by E Corp.’s CFO. Because E Corp. owns only a minority interest, it is not required to consolidate the partnership’s financial results with its own. With such “off-balance-sheet” transactions, E Corp. can report as income whatever profit it receives from its investment. Before SOX, the risks of the investment did not have to be disclosed to E Corp.’s shareholders or the market because the risks “belong to” the partnership rather than to E Corp., and the partnership’s financial results are unconsolidated with E Corp.’s. In many cases this is acceptable, as the partnership is merely an investment. But suppose the partnership were capitalized with E Corp. stock, and further that if the partnership loses money, E Corp. will be required to issue more stock. In this case E Corp. actually is bearing most of the economic risk of the partnership. (Aficionados of corporation law will also immediately recognize the self-dealing in transactions where the issuer provides nearly all the capital to a partnership in which the issuer’s CFO is the majority partner.) Under SOX, the risks of enterprises borne by the issuer must be disclosed.

117. Sarbanes-Oxley Act § 401(c).

118. *Id.* § 401(b).



*E. Earnings Releases and Similar Announcements*

The S.E.C. also has amended Form 8-K to require that earnings releases and similar announcements made to the public be furnished to the S.E.C.<sup>119</sup> The trigger for this requirement is the disclosure of material information regarding a completed fiscal year or quarter.<sup>120</sup> The press release or other announcement is to be appended as an exhibit to a current report on Form 8-K; however, the exhibit will not be considered “filed” with the S.E.C. and the criminal penalties that might otherwise apply to false filings will therefore not be triggered.<sup>121</sup> Similarly, the exhibit would not be automatically incorporated by reference in another document filed with the S.E.C.<sup>122</sup>

*F. Code of Ethics for Financial Officers*

Under SOX, issuers must disclose whether or not they have a code of ethics that applies to their respective senior financial officers and, if not, why not.<sup>123</sup> Any change in such a code must be “immediately” disclosed on Form 8-K.<sup>124</sup> In this context, “code of ethics” means standards that are reasonably necessary to promote (a) honest and ethical conduct; (b) accurate, timely, and understandable disclosure in the issuer’s periodic reports; and (c) compliance with law and regulations.<sup>125</sup> Although SOX does not require issuers to have such a code, its requirement to disclose the absence of such a code and to state reasons why no code is in place, seems clearly intended to apply pressure toward having a code.

*G. Financial Expert on Audit Committee*

SOX requires issuers to disclose whether or not they have on

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119. Final Rule: Conditions for Use of Non-GAAP Financial Measures, Exchange Act Release No. 33-8176 (Jan. 22, 2003), 17 C.F.R. pts. 228, 229, 244 and 249 (2003) (adopting Regulation G and changes to Form 8-K).

120. *Id.*

121. *Id.*

122. *Id.*

123. Sarbanes-Oxley Act § 406(a), 116 Stat. at 789 (to be codified at 15 U.S.C. § 7264).

124. *Id.* § 406(b).

125. *Id.* § 406(c); Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 33-8177 (Jan. 23, 2003), 17 C.F.R. pts. 228, 229 and 249 (2003); Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002; Correction, Exchange Act Release No. 33-8177A (Mar. 26, 2003), 17 C.F.R. pts. 228 and 249 (2003).

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their audit committees at least one member who qualifies as a "financial expert."<sup>126</sup> If no member of the audit committee is a financial expert, the issuer must disclose why.<sup>127</sup> Although the financial expert provisions are framed in terms of disclosure, the goal, as with the code of ethics, appears to aim at pressuring issuers to include at least one financial expert on the audit committee.

#### *H. Real-Time Issuer Disclosures*

All issuers required to report under 1934 Act §§ 13(a) or 15(d) must disclose to the public on a rapid and current basis additional information, to be specified by the S.E.C., concerning material changes in the financial condition or operations of the issuer.<sup>128</sup> These disclosures must be in plain English.<sup>129</sup>

#### *I. Enhanced S.E.C. Review of Periodic Reports*

SOX also requires the S.E.C. to step up the number of reviews it conducts of issuers' periodic reports under the 1934 Act.<sup>130</sup> In addition to suggesting a number of criteria the S.E.C. may use to determine when review is indicated,<sup>131</sup> SOX also requires that all issuers that report under 1934 Act §§ 13(a) or 15(d) be reviewed at least every three years.<sup>132</sup>

### IV. CORPORATE GOVERNANCE REFORMS

Although corporate governance issues are generally considered to be a matter of state corporation law, Congress clearly believed that flawed governance was partly to blame for some of the financial scandals of 2001-02. SOX therefore includes a number of provisions that modify the way corporations are governed, with a special emphasis on strengthening the role of the audit committee. In addition, most loans made by issuers to their directors or executive officers are prohibited, and the latter are prohibited

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126. Sarbanes-Oxley Act § 407(a), 116 Stat. at 790 (to be codified at 15 U.S.C. § 7265).

127. *Id.*; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, *supra* note 125.

128. *Id.* § 409, 116 Stat. at 791 (to be codified at 15 U.S.C. § 78m) (amending § 13 of the Securities Exchange Act of 1934).

129. *Id.*

130. *Id.* § 408(a), 116 Stat. at 790 (to be codified at 15 U.S.C. § 7266).

131. *Id.* § 408(b), 116 Stat. at 790-91.

132. *Id.* § 408(c), 116 Stat. at 791.

from attempting improperly to influence the conduct of audits of the issuer.

#### A. *Audit Committee Reforms*

Many of the Act's substantive governance reforms are directed at strengthening and enhancing the role of the audit committee as a sort of corporate "watchdog." First, no security of an issuer can be listed on a national securities exchange unless the issuer is in compliance with the audit committee requirements.<sup>133</sup> If the issuer has no audit committee, its entire board will be deemed to constitute the audit committee (and will be subject to the audit committee standards).<sup>134</sup>

##### 1. *Audit Committee Responsibilities*

An audit committee is directly responsible for the appointment, compensation, and oversight of the work of the issuer's registered public accounting firm regarding its audit reports and related matters.<sup>135</sup> The committee is also responsible for resolving any disputes between the outside accountants and management over financial reporting,<sup>136</sup> and the outside accountants must report directly to the audit committee.<sup>137</sup> All audit and non-audit services performed by the issuer's outside accountants must be pre-approved by the audit committee.<sup>138</sup> The latter is a significant change from previous practice, when the relationship with the outside accountants was controlled by the issuer's management.

133. Sarbanes-Oxley Act § 301, 116 Stat. at 775 (to be codified at 15 U.S.C. § 78j-1) (adding § 10A(m)(1)(A) to the Securities Exchange Act of 1934); Standards Relating to Listed Company Audit Committees, Exchange Act Release No. 33-8220 (Apr. 9, 2003), 17 C.F.R. pts. 228, 229, 240, 249 and 247 (2003) *available at* <http://www.sec.gov/rules/final/33-8220.htm> (last visited May 19, 2004).

134. Sarbanes-Oxley Act § 205(a), 116 Stat. at 773-74 (to be codified at 15 U.S.C. § 78c) (adding § 3(a)(58) to the Securities Exchange Act of 1934).

135. *Id.* § 301, 116 Stat. at 776 (to be codified at 15 U.S.C. § 78j-1) (adding § 10A(m)(2) to the Securities Exchange Act of 1934).

136. *Id.* (adding § 10A(m)(4)(A) to the Securities Exchange Act of 1934).

137. *Id.*; Securities Exchange Act of 1934, 17 C.F.R. § 240.10A-3(b)(2) (2003).

138. Sarbanes-Oxley Act § 202, 116 Stat. at 772 (to be codified at 15 U.S.C. § 78j-1) (adding § 10A(i)(1)(A) to the Securities Exchange Act of 1934). *See supra* notes 42-48 and accompanying text (regarding pre-approval, in "regulation of accountants").

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Audit committees must establish procedures for receiving, handling, and dealing with complaints regarding accounting, internal controls, or auditing matters.<sup>139</sup> In addition, the audit committee must establish procedures permitting the confidential, anonymous submission of concerns by the employees of the issuer regarding questionable accounting or auditing matters.<sup>140</sup> The audit committee must have authority to hire independent counsel and other advisers as it deems necessary to help it do its job.<sup>141</sup> Issuers must provide funding for the audit committee's payment of compensation to outside accountants and to any advisers hired by the audit committee.<sup>142</sup>

## 2. *Audit Committee Membership*

As noted above,<sup>143</sup> issuers must disclose whether or not they have on their audit committees at least one member who qualifies as a "financial expert." The goal of this "disclosure" requirement appears to be to pressure issuers to include at least one financial expert on the audit committee. Congress used a similar strategy in other sections of SOX.<sup>144</sup> It is difficult to challenge the wisdom of having at least one expert in this role. For this purpose, "experts" are persons having a deep understanding of financial accounting, acquired through experience as (or by supervising) high-level financial officers or public accountants. Other relevant experience may also be considered in deciding whether someone is a financial expert.<sup>145</sup> However, being named as a financial expert on the audit

139. Sarbanes-Oxley Act § 301, 116 Stat. at 776 (to be codified at 15 U.S.C. § 78j-1) (adding § 10A(m)(4)(A) to the Securities Exchange Act of 1934).

140. *Id.* (adding § 10A(m)(4)(B) to the Securities Exchange Act of 1934); 17 C.F.R. § 240.10A-3(b)(3)(2003).

141. Sarbanes-Oxley Act § 301, 116 Stat. at 776 (to be codified at 15 U.S.C. § 78j-1) (adding § 10A(m)(5) to the Securities Exchange Act of 1934); 17 C.F.R. § 240.10A-3(b)(4).

142. Sarbanes-Oxley Act § 301, 116 Stat. at 776-77 (to be codified at 15 U.S.C. § 78j-1) (adding § 10A(m)(6) to the Securities Exchange Act of 1934); 17 C.F.R. § 240.10A-3(b)(5).

143. *See supra* notes 126-127 and accompanying text.

144. *See supra* notes 123-125 and accompanying text.

145. Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 33-8177 (Mar. 3, 2003) 17 C.F.R. pts. 228, 229 and 249 (2003), *available at* <http://www.sec.gov/rules/final/33-8177.htm> (last visited May 19, 2004); Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Correction, Exchange Act Release No. 33-8177A (Mar. 31, 2003), 17 C.F.R. pts. 228, 229 and 249 (2003), *available at* <http://www.sec.gov/rules/final/33-8177a.htm> (last visited May 19, 2004).

committee does not automatically make the named person an expert for other purposes, *e.g.*, for purposes of the “due diligence” defense under Securities Act section 11.<sup>146</sup>

Each audit committee member must be a member of the issuer’s board of directors.<sup>147</sup> In addition, each audit committee member must be independent, meaning that (a) no member may receive fees from the issuer, other than fees for service on the audit committee, the board, or other board committees; and (b) no audit committee member may be an “affiliate” of the issuer.<sup>148</sup> There are some situations, however, in which requiring complete audit committee independence would be burdensome, and the S.E.C.’s rules provide that an issuer “going public” (that is, not previously required to file 1934 Act reports) need only to have *one* independent member of the audit committee for ninety days after the effectiveness of the IPO registration statement. After ninety days, but before the first anniversary of effectiveness, only a majority of the audit committee must be independent.<sup>149</sup>

Similarly, it often happens that the board of directors of two affiliated companies—for example, a parent and a subsidiary—are identical or have some members in common. As long as a director serving on the boards of two or more affiliated companies meets the other requirements for independence from each company, she

146. Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Exchange Act Release No. 33-8177 (Mar. 3, 2003) 17 C.F.R. pts. 228, 229 and 249 (2003), *available at* <http://www.sec.gov/rules/final/33-8177.htm> (last visited May 19, 2004); Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Correction, Exchange Act Release No. 33-8177A (Mar. 31, 2003), 17 C.F.R. pts. 228, 229 and 249 (2003), *available at* <http://www.sec.gov/rules/final/33-8177a.htm> (last visited May 19, 2004).

147. Sarbanes-Oxley Act § 301, 116 Stat. at 776 (to be codified at 15 U.S.C. §78j-1) (adding § 10A(m)(3) to the Securities Exchange Act of 1934); 17 C.F.R. § 240.10A-3(b)(1)(i) (2003).

148. Sarbanes-Oxley Act § 301, 116 Stat. at 776 (to be codified at 15 U.S.C. §78j-1) (adding § 10A(m)(3)(B)); 17 C.F.R. § 240.10A-3(b)(1). “Affiliate” is defined as a person controlling, controlled by, or under common control with the issuer. 17 C.F.R. § 240.10A-3(c)(1)(i). “Control” is defined the same way that it is in SA rule 405 (*i.e.*, the power to direct or cause the direction of the management and policies of the issuer). *See* Sarbanes-Oxley Act § 405. The following persons are deemed to be affiliates of the issuer: executive officers of an affiliate of the issuer, directors who also are employees of an affiliate of the issuer, general partners of an affiliate of the issuer, and managing members of an affiliate of the issuer. Persons who are neither executive officers nor own more than ten percent of any class of voting equity securities of the issuer are deemed not to be “affiliates” (and thus are allowed to serve on the issuer’s audit committee). 17 C.F.R. § 240.10A-3(e)(1)(ii)(A).

149. 17 C.F.R. § 240.10A-3(b)(1)(iv)(A).

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will not be considered an affiliate solely because she serves on the board of an affiliated company.<sup>150</sup>

In any case, the S.E.C.'s exclusion of "affiliates" from the audit committee is only the starting point for defining the independence of audit committee members. Stock exchanges and markets, in particular, are well-positioned to raise the bar for independence even higher by adding additional requirements to their standards for listing issuers' securities. Both the NYSE and NASDAQ have proposed standards, discussed below, tougher than those mandated by the S.E.C. to ensure audit committee independence.

*a. NYSE Proposed Standard for Independence*

The New York Stock Exchange proposal goes well beyond what SOX requires, in that an independent director for NYSE purposes has no direct or indirect material relationship with the issuer. Former employees of the issuer or the outside accountants (and a few additional categories of persons) would not be considered independent until five years had passed from the date of their most recent employment with either the issuer or the accountants.<sup>151</sup>

*b. NASDAQ Proposed Standard for Independence*

The NASDAQ market has also proposed a definition of independence that, as applied to audit committee members, would exclude anyone receiving payments other than director's fees, and anyone who is the executive officer of a charity that received substantial contributions from the issuer.<sup>152</sup> Similar to the NYSE standard, former employees of the issuer or its accountants, and some others, would not be considered independent until three years have passed since their disqualifying employment.<sup>153</sup>

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150. *Id.* § 240.10A-3(b)(1)(iv)(B).

151. Self Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the New York Stock Exchange, Inc. relating to Corporate Governance, Exchange Act Release No. 34-47672 (Apr. 11, 2003), 68 Fed. Reg. 19051 (Apr. 17, 2003), *available at* <http://www.sec.gov/rules/sro/34-47672.htm> (last visited May 19, 2004).

152. Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the National Association of Securities Dealers, Inc. Relating to Proposed Amendments to NASD Rules 4200 and 4350 Regarding Board Independence and Independent Committees, Exchange Act Release No. 34-47516 (Mar. 17, 2003), 68 Fed. Reg. 14,451 (Mar. 25, 2003), *available at* <http://www.sec.gov/rules/sro/34-47516.htm> (last visited May 19, 2004).

153. *Id.*

*B. Prohibition Against Personal Loans*

SOX prohibits personal loans from an issuer (or its affiliates) to a director or executive officer of the issuer.<sup>154</sup> Because issuers have historically advanced funds to directors and officers in a wide variety of situations, the exact reach of the prohibition is still unclear. Loans by certain issuers are exempted from the prohibition; issuers that have a consumer credit business may make personal loans to directors and executive officers if the loans are on the same terms and of a type generally made available to the public.<sup>155</sup> Of course, loans of a type and on the terms available to the public are not generally as attractive to the issuer's directors and officers as the previously available, favorable loans.

Advances of litigation expenses incurred by officers or directors as the result of their service to the issuer may or may not be "personal loans." Officers and directors are often entitled to such advances as a matter of contract right, either by a provision in their employment agreements or by a corporate bylaw. Perhaps the answer will depend upon whether the officer or director wins or loses the lawsuit. A win might make the litigation advance a contractual right; a loss, on the other hand, often involves the individual repaying the advances to the issuer and thus might be considered a "personal loan."

Issuers often fund short-term loans to directors and officers for the exercise of stock options. These loans are usually repaid within days, when the underlying stock is sold. The exercise price is refunded to the issuer, and the officer or directors keeps the difference between the exercise price and the market price. Such plans are called "cashless option exercise." Similarly, many issuers obtain and pay for life insurance on officers and directors. When the insured individuals can borrow against the value of the policy, this is called "split-dollar" insurance. Such arrangements can be characterized as loans from the issuer, since the value against which the loan is made has been funded by the issuer. The status of plans like split-dollar insurance and cashless option exercise under SOX is currently unknown.

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154. Sarbanes-Oxley Act § 402(a), 116 Stat. at 787 (to be codified at 15 U.S.C. § 78(m)) (adding § 13(k)(1) to the Securities Exchange Act of 1934).

155. *Id.* (adding § 13(k)(2) to the Securities Exchange Act of 1934).

*C. Prohibition Against Improper Influence on Conduct of Audits*

SOX section 303 states that it is illegal for an officer or director of an issuer to try to influence an audit in a way that violates S.E.C. rules,<sup>156</sup> and under section 303, the S.E.C. has adopted new 1934 Act rule 13b2-2(b).<sup>157</sup> Subdivision (1) of this rule prohibits officers and directors (and their respective agents) from coercing, manipulating, misleading, or fraudulently influencing the issuer's auditors when the officer, director or other person knew or should have known that the action, if successful, could result in rendering the issuer's financial statements materially misleading.<sup>158</sup> For example, it would be an attempt to improperly influence an audit if an officer or director were to try to persuade auditors to issue or reissue a report on an issuer's financial statements that is not warranted in the circumstances (due to material violations of generally accepted accounting principles, generally accepted auditing standards, or other professional or regulatory standards), or not to perform audit, review, or other procedures required by generally accepted auditing standards or other professional standards, or not to withdraw an issued report, or not to communicate matters to an issuer's audit committee.<sup>159</sup>

If an issuer has to restate its financial reports due to misconduct, its CEO and CFO must reimburse the issuer for any bonus or compensation based on equity (*e.g.*, stock options, "phantom" stock, etc.) received during the twelve months after the defective, later-restated report was filed, plus profits from the sale of securities during the same twelve-month period.<sup>160</sup>

*D. No Insider Trades During Pension Fund Blackouts*

"Pension fund blackouts" are periods when pension fund participants may not engage in trades of the securities held in their accounts. In the Enron case, many employees were furious to learn that during a pension fund blackout—and while Enron's stock price was plummeting—senior executives were cutting their losses

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156. *Id.* § 303(a), 116 Stat. at 778 (to be codified at 15 U.S.C. § 7242).

157. Final Rule: Improper Influence on Conduct of Audits, Exchange Act Release No. 34,47890 (May 20, 2003), 17 C.F.R. pt. 240 (2003).

158. 17 C.F.R. § 240.13b2-2(b)(1).

159. *Id.* § 240.13b2-2(b)(2).

160. Sarbanes-Oxley Act § 304, 116 Stat. at 778 (to be codified at 15 U.S.C. § 7243).



by selling large quantities of Enron stock. The employees, of course, were prohibited from selling during the blackout. SOX responds to this by prohibiting the directors and executive officers of an issuer from selling the issuer's equity securities if a pension fund blackout is in effect.<sup>161</sup> This prohibition applies to all equity securities acquired in connection with service or employment as a director or executive officer.<sup>162</sup> Insider transactions are prohibited when a pension fund blackout (a) lasts for more than three business days and (b) suspends the ability of at least fifty percent of the plan participants to engage in plan transactions involving the issuer's equity securities.<sup>163</sup> Issuers must notify plan participants,<sup>164</sup> their directors and executive officers, and the S.E.C. of any blackout.<sup>165</sup>

## V. ENHANCED ENFORCEMENT

In addition to the many changes and additions to the law made by SOX and already described, SOX creates new crimes, stiffens penalties for existing crimes, enhances the S.E.C.'s enforcement authority, extends the statute of limitations in private actions for securities fraud, protects whistleblowers in securities cases, and provides that debts arising from judgments in securities cases are not dischargeable in bankruptcy.

### A. Crimes

Under SOX, it is now a crime to tamper with, hide, or destroy documents with the intent to impede or influence an investigation by a United States government agency; the penalties include fines and imprisonment for up to twenty years.<sup>166</sup> Another newly created crime relates to accountants' maintenance of audit records and work papers; accountants are required to maintain all records

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161. *Id.* § 306(a), 116 Stat. at 779 (to be codified at 15 U.S.C. § 78u).

162. *Id.*

163. *Id.* § 306(a)(4).

164. *Id.* § 306(b), 116 Stat. at 780 (to be codified at 29 U.S.C. § 1021) (amending § 101 of the Employees Retirement Income Security Act of 1974 (ERISA) by adding (i)(2)).

165. *Id.* § 306(a)(6).

166. *Id.* § 802(a), 116 Stat. at 800 (to be codified at 18 U.S.C. § 1519). The same conduct can often be prosecuted under federal obstruction-of-justice laws, but the advantage of the newly created SOX crime is that it is relatively easy to prove and carries a stiff sentence.

related to an audit for five years after the audit.<sup>167</sup> Failure to do so may result in a fine and imprisonment for up to ten years.<sup>168</sup>

SOX also created a new crime of defrauding shareholders of public companies.<sup>169</sup> The offense is defined as actual or attempted fraud in connection with a security of an issuer<sup>170</sup> regulated by SOX. The punishment is a fine and up to ten years in prison.<sup>171</sup> Under the new regime requiring officers to certify issuers' financial statements, it is also a crime for a corporate officer to falsely certify financial statements<sup>172</sup> contained in a report filed with the S.E.C.<sup>173</sup>

SOX amends the existing crime of "tampering with a record or otherwise impeding an official proceeding"<sup>174</sup> by adding the offense of actual or attempted alteration, destruction, or concealment of a record or other object to impair its availability for use in an official proceeding, or other corrupt actual or attempted obstruction of or influence on an official proceeding. This crime is punishable by a fine and up to twenty years' imprisonment.<sup>175</sup>

### *B. Criminal Penalties*

In addition to broadening the conduct that is considered criminal, SOX enhances sentencing for financial crimes, fraud and obstruction of justice. First, SOX increases the prison sentences for mail and wire fraud from five years to twenty years.<sup>176</sup> SOX also increases the prison sentences for violation of ERISA from one year to ten years; fines for ERISA violations are increased for individuals from \$5000 to \$100,000, and for others from \$100,000 to \$500,000.<sup>177</sup> Similarly, SOX increases the penalties for individuals who violate the 1934 Act from a fine of \$1 million and a prison term of ten years, to a fine of \$5 million and a prison term of

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167. *Id.* (to be codified at 18 U.S.C. § 1520(a)).

168. *Id.* (to be codified at 18 U.S.C. § 1520(b)). *See* Retention of Records Relevant to Audits and Reviews, Exchange Act Release No. 33-8180 (Jan. 24, 2003), 17 C.F.R. pt 210 (2003).

169. Sarbanes-Oxley Act §807(a) 116 Stat. at 804 (to be codified by adding 18 U.S.C. § 1348).

170. *See supra* notes 12-14 and accompanying text.

171. Sarbanes-Oxley Act § 807.

172. *See supra* notes 103-110 and accompanying text.

173. *Id.* § 906, 116 Stat. at 806 (to be codified at 18 U.S.C. § 1350). *See supra* note 105 and accompanying text.

174. *Id.* § 1102, 116 Stat. at 807 (to be codified at 18 U.S.C. § 1512).

175. *Id.*

176. *Id.* § 903, 116 Stat. at 805 (to be codified at 18 U.S.C. §§ 1341, 1343).

177. *Id.* § 904, 116 Stat. at 805 (to be codified at 29 U.S.C. § 1131).

twenty years.<sup>178</sup> The fine for corporate violators is increased from \$2.5 million to \$25 million.<sup>179</sup>

SOX also requests the United States Sentencing Commission to review and, if appropriate, amend the sentencing guidelines for a number of criminal violations, including financial and accounting fraud,<sup>180</sup> obstruction of justice and “extensive criminal fraud,”<sup>181</sup> “fraud and related offenses” committed by officers or directors of public companies,<sup>182</sup> and violations of SOX in general.<sup>183</sup>

In an action for an injunction under either the 1933 or 1934 Acts, the S.E.C. since 1990 may request the court to bar the defendant from serving as an officer or director of an issuer.<sup>184</sup> Previously, the standard necessary to impose such a ban was a showing of the defendant’s “substantial unfitness to serve”; SOX amended the requirement to eliminate “substantial,” basing the bar on mere “unfitness to serve.”<sup>185</sup> Finally, in an action for an injunction brought by the S.E.C. under the 1934 Act, the S.E.C. may seek any additional equitable relief that “may be appropriate or necessary for the benefit of investors.”<sup>186</sup>

### C. Secondary (“Aiding and Abetting”) Violations

To this point we have considered changes in the law explicitly affecting certain securities professionals—accountants, lawyers, and analysts. Before 1994, these persons were frequently sued or prosecuted under theories of secondary criminal liability for aiding and abetting the primary violations of others (typically issuers). In 1994, however, the Supreme Court held, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,<sup>187</sup> that there is no private

178. *Id.* § 1106, 116 Stat. at 810 (adding § 78ff(a) to § 32(a) of the Securities Exchange Act of 1934).

179. *Id.*

180. *Id.* § 1104, 116 Stat. at 808 (to be codified at 28 U.S.C. § 994).

181. *Id.* § 805, 116 Stat. at 802 (to be codified at 28 U.S.C. § 994).

182. *Id.* § 1104.

183. *Id.* § 905, 116 Stat. at 805 (to be codified at 28 U.S.C. § 994).

184. Securities Act of 1933 § 20(e), 15 U.S.C. § 77t(e) (2000); Securities Exchange Act of 1934 § 21(d), 15 U.S.C. § 78u(d)(2) (2000).

185. Sarbanes-Oxley Act § 305(a), 116 Stat. at 779 (to be codified at 15 U.S.C. §§ 77t(e), 78u(d)(2)) (adding § 77t(e) to § 20(e) of the Securities Act of 1933 and § 78u(d)(2) to § 21(d) of the Securities Exchange Act of 1934).

186. *Id.* § 305(b), 116 Stat. at 779 (adding § 78u to § 21(d)(5) of the Securities Exchange Act of 1934).

187. 511 U.S. 164 (1994).

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right of action against one who aids and abets a rule 10b-5 violation. Indeed, the language of *Central Bank* was broad enough to possibly foreclose even S.E.C. actions against aiders and abettors. To dispel this possibility, in 1995 Congress added section 20(e) to the 1934 Act, making it clear that the S.E.C. can sue aiders and abettors under rule 10b-5, even though private citizens cannot.<sup>188</sup> The force of *Central Bank* may now be diminishing, perhaps as the result of legislation or perhaps judicial reinterpretation. The Enron, Worldcom and Adelphia cases, in which investors lost billions, present a powerful argument for letting private investors sue secondary actors who facilitate the violations of those primarily liable.

Section 703 of SOX directs the S.E.C. to study data from 1998 through 2001 to determine (among other things) how many accountants, accounting firms, investment bankers, investment advisers, brokers, dealers, lawyers, and other professionals practicing before the S.E.C. were found to have aided and abetted a violation of the securities laws but were not sanctioned as primary violators.<sup>189</sup> The Commission is to report to Congress, which, if it is sufficiently concerned, could take action legislatively to overrule *Central Bank*.

At least one court is also trying to avoid the impact of *Central Bank*. In the securities class action arising out of the Enron bankruptcy, the court has ruled that "secondary actors may be liable for primary violations" of 1934 Act rule 10b-5, as long as the rule's requirements are met with respect to each secondary actor and the action is properly pleaded.<sup>190</sup> Although the court recognized that the 1995 Act was designed to cut back on securities litigation by private plaintiffs, the court noted that the 1995 Act "is a mechanism for winnowing out suits that lack [sufficient] specificity. It was not meant to let business and management run amuck to the detriment of shareholders."<sup>191</sup>

## VI. CONCLUSION

SOX is likely the broadest and farthest-reaching securities

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188. 15 U.S.C. § 77t(e) (2000).

189. Sarbanes-Oxley Act § 703(a).

190. *In re Enron Corp. Secs. Derivative & ERISA Lit.*, 235 F. Supp. 2d 549, 592 (S.D. Texas 2002).

191. *Id.* at 593 (quoting *Abrams v. Baker Hughes, Inc.*, 292 F.3d 424, 435-36 (5th Cir. 2002) (Parker, C.J., concurring)).

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reform legislation passed since the Securities Exchange Act of 1934. Its reach extends beyond merely regulation the issuance and trading of securities, to corporate governance and the standards applicable to the practice of accounting and law. SOX is an ambitious attempt to add “teeth” to the regulation of public corporations. Ultimately, however, its success will depend upon corporate compliance. No amount of additional legislation can guarantee a safe investment environment; in the end, the continued attractiveness of U.S. capital markets will depend upon corporate self-regulation.